Internal Revenue Service
memorandum

CC:W:DEN:TL-N-2338-99
MSHeroux

date: 17 JUN 1999

to: Case Manager E:2:9 4209DEN

from: District Counsel, Rocky Mountain District CC:WR:RMD:DEN

subject: [redacted]
Time of Deduction for Interest Paid [redacted]

Your office has requested advice regarding the following issue:

ISSUES

1. Whether I.R.C. § 267(a)(2) prohibits the accrual basis taxpayer from claiming a deduction on [redacted], for interest paid to related shareholders on [redacted], when the taxpayer's tax year ended on [redacted].

2. Whether interest payments made on [redacted], are deductible as of [redacted], *under the doctrine of constructive receipt.*

CONCLUSIONS

1. Under I.R.C. § 267(a)(2), the accrual basis taxpayer can only claim a deduction for interest paid to related shareholders on the date of payment.

2. Interest payments made on [redacted] were not constructively received on [redacted], as the shareholders did not have an unrestricted right to receive the payments until [redacted]. These payments are deductible on [redacted].

FACTS

The taxpayer uses a 52/53 week accounting period ending on the Saturday closest to [redacted]. FY[redacted]'s last day was [redacted]; FY[redacted]'s last day was [redacted]; FY[redacted]s last day was [redacted]. Until [redacted] the taxpayer was an S-Corporation. After [redacted], the taxpayer was a C Corporation. On [redacted], The taxpayer executed a Subordinate Note in the amount of $[redacted] to distribute most of the Sub-S Accumulated Adjustment Account balance to its four shareholders. The S Corp. and the C Corp. had the same [redacted] shareholders. The note states that interest shall accrue on the unpaid principal balance at the rate of [redacted]% per annum from the date of the Note until paid. Accrued interest due under the Note shall be paid semi-annually, beginning [redacted]. On [redacted], the unpaid principal, interest, and any other items payable under this note are due and payable in full as a balloon payment. The Note may be prepaid without penalty, subject to the Subordination Agreement. Interest shall be paid to and including the date of any prepayment. The Note is governed by and construed according to the laws of the State of Colorado. The Subordination Agreement prohibited prepayment of the Note without prior approval of taxpayers' creditors. At the time of the taxpayers' [redacted] deduction, and the [redacted] payment, the taxpayer had creditors whose approval would have had to have been obtained prior to prepayment on the Note. The taxpayer states that approval to make the [redacted] interest payments on [redacted] would have easily been obtained.

On [redacted], interest payments were made to the shareholders for the period from [redacted] to [redacted], in the aggregate amount of $[redacted]. Subsequent interest payments, each in the aggregate amount of $[redacted] were made on [redacted], [redacted] and [redacted] The $[redacted] figure was determined by computing a full year's interest on the debt and dividing by two. During its audit of the taxpayer's FY[redacted], [redacted] questioned the [redacted], deduction. It was their opinion that IRC § 267(a)(2) required the taxpayer to take the deduction for the [redacted], payment in FY[redacted] as opposed to FY[redacted] On [redacted] the taxpayer's Tax Manager recommended that each year's [redacted] interest payment be made by the end of each fiscal year to reduce the possibility of the payment being questioned. The taxpayer states that the Note has been paid in full. Interest was accrued monthly on the taxpayer's general ledger. The shareholders are calendar year taxpayers.

The IRS takes the position that under I.R.C. § 267(a)(2), the November 1, [redacted] payment is not deductible in FY[redacted]. The taxpayer alleges:

1. Section 267(a)(2) is not applicable as the parties do not report the interest in different years due to different methods of accounting, but because the parties use different taxable years.

2. The taxpayer's shareholders reported the interest paid November 1, [redacted] on their [redacted] quarter [redacted] estimated tax return. On [redacted] the taxpayer filed its FY[redacted] return and paid the tax due shown on the return. On [redacted], the taxpayer's shareholders filed their [redacted] estimated tax return and paid the tax allocable to the [redacted] interest payments. The shareholders' [redacted] quarter overlaps the last twenty-eight days of taxpayer's FY[redacted] Section 267(a)(2) is therefore not applicable as the

shareholders report the income and the taxpayer claims the deduction during the same tax period.

3. If § 267(a)(2) is applicable, the interest payment made on [redacted] is deductible in FY[redacted] as the payment was constructively received by the payees on [redacted]. The amount of interest due each shareholder on [redacted], had been determined; the funds for payment were available; and the payees as officers, directors, and shareholders of the corporation would have authorized withdrawal of the funds at the end of FY[redacted].

The IRS agrees that the taxpayer had sufficient funds to make the payments on [redacted].

LEGAL ANALYSIS

Section 267(a)(2)

As amended in 1984, I.R.C. § 267(a)(2) provides for a matching of interest deductions and income where, in the case of related persons, the payor is an accrual basis taxpayer and the payee is on a cash basis method of accounting. Section 267(a)(2) specifically provides: "If--

> (A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and
> (B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are (related) persons,
>
> then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made.

The purpose behind the 1984 amendment was to require related persons, "to use the same accounting method with respect to transactions between themselves in order to prevent the allowance of a deduction without the corresponding inclusion in income." H. Rep. No. 432, 98th Cong., 2d Sess. 1578 (1984). The Ways and Means Committee further stated that, "[t]he failure to use the same accounting method with respect to one transaction involves unwarranted tax benefits, especially where payments are delayed for a long period of time, and in fact may never be paid." *Id.* "Under the bill, an accrual basis taxpayer will be placed on the cash method of accounting with respect to deductions of business expenses and interest owed to a related cash-basis taxpayer." *Id.* Congress thus amended section 267(a)(2) to require an accrual basis taxpayer to deduct interest owed to a related cash basis taxpayer when payment is made. *Id.* Congress explained that, "[i]n other words, the deduction by the payor will be allowed no earlier than when the corresponding income is recognized by the payee." *Id.* Congress concludes, "This provision will apply to all deductible expenses the timing of which depends upon the taxpayer's method of accounting or upon the making of an election to expense an item." *Id.*

The facts of this case are very simple: the taxpayer accrued and reported an interest expense on the last day of its fiscal year ended [redacted] payment was made to its cash basis shareholders on [redacted]. Under § 267(a)(2), the accrual basis taxpayer is required to deduct the interest when payment is made, which in this case is the fiscal year ended November 2, [redacted]. In Cleveland Trencher Co. v. Commissioner, T.C. Memo. 1996-489, the Tax Court held that § 267(a)(2) would apply to disallow a taxpayer's accrued deduction for unpaid commissions in the year claimed because the payment to a related cash basis party could not be deducted until paid. In that case, the taxpayer accrued and deducted commissions paid to a related entity. The Tax Court stated that not only did the accrual of the commissions not meet the all events test, but that even if the test were met, since the payee was a cash basis taxpayer the deduction could not be claimed in the year at issue, but only could be deducted when paid. *See also* Wise v. Commissioner, T.C. Memo. 1997-135, (accrual basis taxpayer can only claim interest expense when the interest is Includible in the gross income of the cash basis payee).

The taxpayer relies on Tate & Lyle, Inc. v. Commissioner, 103 T.C. 656 (1994), *rev'd,* 96-2 USTC ¶ 50340 (3d Cir. 1996), to support its position that the matching principle of § 267(a)(2) does not apply to this case. In Tate & Lyle, a U.S. subsidiary owed its U.K. parent interest based on loans made to the subsidiary by the parent. Under the U.S.-U.K. tax treaty, interest income not effectively connected with a U.S. trade or business is exempt from U.S. tax. Normally, interest income received by a foreign corporation from sources within the U.S. and which is not effectively connected with a trade or business in this country, is reported on the cash basis method of accounting under I.R.C. §§ 881 and 1442. The Commissioner argued that under I.R.C. § 267(a)(3) and Treas. Reg. § 1.267(a)-3 (legislation enacted to address situations where interest payments to foreign entities are exempt from U.S. income tax), petitioners were required to use the cash method of accounting with respect to the deduction of interest owed to the foreign parent. The Tax Court invalidated Treas. Reg. § 1.267(a)-3, and then declined to apply I.R.C. § 267(a)(2) to the interest deduction claimed by petitioners. The Tax Court in Tate & Lyle stated that the § 267(a)(2) matching principle is triggered when:

> (1) a taxpayer incurs an expense that would otherwise be deductible;
> (2) the taxpayer and payee are related; and
> (3) by reason of the payee's method of accounting, the item is not includible in the payee's income during the same year that it would otherwise be deductible by the taxpayer.

In that case, the Tax Court held that it was not the foreign parent's method of accounting which prevented inclusion of the interest in the foreign parent's income; it was the exemption provided by the U.S.-U.K. treaty. On appeal, the Third Circuit reversed the Tax Court, holding that Treas. Reg. § 1.267(a)-3 was a valid exercise of the Commissioner's rule making authority. As petitioners were required to use the cash method of accounting under this regulation, the appeals court did not address the Tax Court's application of I.R.C. § 267(a)(2) to the facts of that case.

In the instant case, the taxpayer argues that like the petitioners in Tate & Lyle, it is not the accounting methods of the shareholders that prevent inclusion of the interest income in the same year that the interest expense is deducted by the taxpayer. The taxpayer argues that the shareholders did include the interest income in the closest year ([redacted]) ending to the taxpayer's fiscal year ending October 28, [redacted]. The reason why the shareholders did not include this interest in the taxable year ending October 28, [redacted], was because of the different taxable years used by the parties, not the different accounting methods used.

The taxpayer's argument is not persuasive. Assuming the shareholders' taxable years ended October 28, [redacted], they would not include the interest in income because they are cash basis taxpayers and the interest was not paid until [redacted]. It is not different taxable years which prevent the shareholders from recognizing the interest income in the same tax period as the interest deduction is claimed by the taxpayer. It is the shareholders' cash basis method of accounting which prevents the interest from being included in the shareholders' income during the same year that it would otherwise be deductible by the taxpayer.

This case is exactly the type of case Congress intended to be addressed by § 267(a)(2). Section 267(a)(2) was amended in 1984 to require related persons, "to use the same accounting method with respect to transactions between themselves in order to prevent the allowance of a deduction without the corresponding inclusion in income." It was intended to "require an accrual basis taxpayer to deduct interest owed to a related cash basis taxpayer when payment is made. . . .The deduction by the payor will be allowed no earlier than when the corresponding income is recognized by the payee."

The taxpayer states that it is the fact that the taxpayer and its shareholders use different taxable years that makes it impossible for the parties to account for the transaction for tax purposes in the same tax period. Therefore congress' statement that, "This provision will apply to all deductible expenses the timing of which depends upon the taxpayer's method of accounting or upon the making of an election to expense an item," supports its position. The taxpayer's narrow interpretation of the legislative history would not likely persuade a court to allow the taxpayer to avoid the repeated intent of the statute. While literally true in the taxpayer's case (all events had been met to allow accrual of the interest expense in FY[redacted] for the payment made on [redacted]), it is also true that it is the parties' different methods of accounting which prevent them from reporting the transaction in the same tax year. It is also true that if the parties were on the same fiscal year ending October 28, [redacted] they would not be able to report the transaction in the same tax year because of their different methods of accounting. The taxpayer's argument, that different tax periods prevent the related parties from reporting the transaction in the same tax year, is the very issue that § 267(a)(2) was intended to address.

The taxpayer also cites to Summit Sheet Metal Co. v. Commissioner, T.C. Memo. 1996-563, to support its position that it can accrue the interest expense in FY[redacted] The taxpayer submits that in Summitt, the IRS argued that the accrual basis taxpayer had to take the expense in the year accrued as opposed to the year in which the cash basis payees were actually paid. Summit applies to this case not for the proposition proposed by the taxpayer, but for the proposition that taxpayers will not be allowed to use literal applications of facts to statutes to avoid the clear intent of the law. Summit involved a taxpayer that was switching from C to S corporate status, and due to a significant capital gain in the year at issue, the taxpayer was liable for the § 1374(a) tax on net recognized built-in gain. In order to eliminate the § 1374(a) tax, the taxpayer attempted to increase its income by reducing the amount of bonuses paid to its employees claimed on its return. It argued that § 267(a)(2) required the accrual basis taxpayer to report the expense in the subsequent tax year when its cash basis employees actually received the bonuses. The IRS argued that the taxpayer had to claim the deduction in the year accrued because it had a 20-year history of accruing for the expense in this fashion, and to allow a change in method of accounting for the bonuses without first obtaining the consent of the Secretary violated § 446(e). The IRS argued that even if 267(a)(2) did apply, Summit's deduction should be claimed when it accrued as the employees constructively received their bonuses in the accrual year (the bonuses had been determined as of the close of FY9709, cash for payment was available, and those who were owed the bonuses had the authority to make payment). The Tax Court saw through the taxpayer's attempt to use § 267(a)(2) in a manner inconsistent with other sections of the Code. The Court held for the Commissioner and further stated that taxpayers' argument that approval under § 446(e) is not required when the accounting change is mandated by law, was not supported by the fact that the taxpayer had not raised the § 267(a)(2) argument until 1994, after the audit and ten years after passage of § 267(a)(2). In Summit, as in the present case, § 267(a)(2) applies. The difference is that in Summit a decision not to apply § 267(a)(2) was supported by the facts of that case, whereas a decision not to apply § 267(a)(2) in the present case is not supported by its facts.

Alternatively, the taxpayer argues that § 267(a)(2) is not applicable because the shareholders report the interest income on their [redacted] quarter estimated tax return which overlaps the end of taxpayer's FY[redacted] Section 267(a)(2) was designed to prevent the allowance of a deduction without the corresponding inclusion in income. The shareholders included the interest in income during the period beginning [redacted], and ending [redacted] The taxpayer claimed the deduction on [redacted]. Therefore the deduction and the corresponding inclusion of income take place at the same time. This argument is also not persuasive. The issue is not when is the income reported or what period is covered by a return which reports the income. The issue is when is the income Includible in the gross income of the payee. It is then that the deduction may be claimed by the payor. Section 267(a)(2) as well as many other provisions of the Code require a daily tax transaction analysis. Where payments are made to related shareholders, the deduction for the payments are, "allowable as of the *day* as of which such amount is includible in the gross income of the person to whom the payment is made." The fact that the shareholders reported the income on a quarterly return which includes the month of [redacted] does not mean that the interest income was Includible in the gross income of the shareholders on any day in [redacted] Taxpayers on the cash basis of accounting report income when the payment is received. *See* W.L. Moody Cotton Co. v. United States, 143 F.2d 712 (5th Cir. 1944); Atlantic Discount Co. v. United States, 473 F.2d 412 (5th Cir. 1973). The interest income was Includible in the shareholders' income on November 1, 1995. Under I.R.C. § 267(a)(2), it is on that day that the taxpayer may claim the deduction.

Constructive Receipt

The taxpayer argues that if § 267(a)(2) applies, then the expense may still be claimed in FY[redacted] since the payments were constructively received by the shareholders on [redacted]. The Subordinate Note provided for prepayment without any penalty. As the controlling shareholders of the taxpayer, the shareholders could have ordered prepayment at any time.

A cash basis taxpayer must include in its income amounts which it actually or constructively received. Treas. Reg. § 1.451-1(a); Corliss v. Bowers, 281 U.S. 376 (1930); Wise, T.C. Memo 1997-135. Whether a taxpayer constructively received income is a question of fact. Avery v. Commissioner, 292 U.S. 210 (1934); Willits v. Commissioner, 50 T.C. 602 (1968). Income is constructively received by a taxpayer when it is credited to his account or set apart for him so that he may draw upon it at any time without substantial limitation or restriction. Treas. Reg. § 1.451-2; Geiger & Peters, Inc. v. Commissioner, 27 T.C. 911 (1957). The doctrine of constructive receipt is to be sparingly applied, and where income is not unqualifiedly subject to the taxpayer's demand and his failure to receive it is not the result of his own choice, there is no constructive receipt. Basila v. Commissioner, 36 T.C. 111 (1961). In addition, the payor must have the cash or the ability to borrow to make the payment. Estate of Noel v. Commissioner, 50 T.C. 702 (1968).

In this case, there is no question that the taxpayer had the cash to make the interest payments on [redacted]. The issue is whether there were substantial limitations to the shareholders' ability to receive the [redacted], interest payment on [redacted]. In this case, the Subordinate Notes called for payments to be made [redacted] beginning [redacted]. Payments were made [redacted] on [redacted] and [redacted] in [redacted] and [redacted]. The taxpayer contends that the controlling shareholders easily could have ordered the payments on [redacted], or amended the Notes to call for payment on [redacted]. It is the right rather than the power to receive income that determines whether such income is constructively received, Bisset & Son, Inc. v. Commissioner, 56 T.C. 453, 463 (1971). In this case the right to receive the interest payment in question was limited by the Subordinate Note to [redacted]. The Subordinate Note indicates that the interest "may" be prepaid. "May" be prepaid does not equate to the "right" to prepayment. In Young Door Co. v. Commissioner, 40 T.C. 890 (1963), the Tax Court held that where a corporate record limited the right to receive sales commissions to a fixed date, the income was subject to substantial restriction and was not constructively received until the conditions imposed by the corporate record were met despite the controlling taxpayer's contentions that the payments could have been ordered at any time. *See also* K.W. Hereford Farms, Inc. v. Commissioner, T.C. Memo. 1967-163, (mere existence of the taxpayer's power to accelerate payment of a debt to a related corporation did not constitute constructive receipt); Basila, 36 T.C. 111 (1961), (where amounts were not due and payable under an employment contract until a fixed date, the court found that receipt of such amounts were subject to substantial limitations and were not constructively received by the taxpayer until the date fixed in the contract). Furthermore, in this case, the Subordination Agreement prohibited prepayment of the interest without prior approval of the taxpayer's creditors. This limitation on the shareholders' "right" to prepayment of interest prohibits application of the doctrine of constructive receipt.

We conclude that the taxpayer cannot claim a deduction in FY[redacted] for the interest payment made [redacted]. Under I.R.C. § 267(a)(2), the deduction must be claimed in FY[redacted] If you have any questions regarding this memorandum, please contact Mark S. Heroux of this office at 844-2214 ext. 225.

MARTIN B. KAYE
District Counsel

By:
JERRY L. LEONARD
Assistant District Counsel